

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-2102-00
GAKindel

date:

JUN 14 2000

to:

[REDACTED], Associate Chief

from:

District Counsel, Southern California District, San Diego

subject:

[REDACTED] -- Sale of Section 1244 Stock

This memorandum supercedes the memorandum dated May 19, 2000, and responds to your request for advice concerning whether, and to what extent, [REDACTED] (the "Taxpayer"), a nonresident alien, is entitled to an ordinary loss pursuant to I.R.C. § 1244 on the sale of stock qualifying as small business stock within the meaning of I.R.C. § 1244.

DISCLOSURE LIMITATIONS

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether the loss realized by the Taxpayer, a nonresident alien, on the sale of his stock in [REDACTED], a California corporation, is sourced in the United States.

If so, whether the Taxpayer is entitled to claim an ordinary loss in the amount of \$[REDACTED] under I.R.C. § 1244 on the sale of such stock, as claimed by the Taxpayer, or in the amount of \$[REDACTED], as claimed by the Service.

CONCLUSION

At this stage, we do not have sufficient facts to determine whether the loss is sourced in the United States. Stock in a U.S. corporation is presumed to be a United States real property interest under I.R.C. § 897, and any gain or loss from the sale of such stock is treated as effectively connected to the conduct of a trade or business in the United States. The Service, however, can overcome this presumption. We recommend that the Service obtain additional facts to determine whether the Taxpayer's stock in [REDACTED] should be treated as a United States real property interest.

FACTS

The Taxpayer is a [REDACTED] who is a citizen and resident of Mexico. The Taxpayer does not maintain an office or other fixed place of business in the United States.

[REDACTED] is a California corporation that was organized in [REDACTED] to operate a [REDACTED] in San Diego, California. In [REDACTED], the Taxpayer purchased [REDACTED] shares of [REDACTED]'s stock for \$[REDACTED]. In [REDACTED], the Taxpayer purchased an additional [REDACTED] shares for \$[REDACTED].

[REDACTED] ceased doing business in [REDACTED] and filed its final income tax return in [REDACTED]. On its final return, [REDACTED] reported capital stock in the amount of \$[REDACTED]. [REDACTED] also reported the following assets and liabilities:

ASSETS

Cash		
Trade Receivables		
Inventories		
Buildings and Depreciable Assets		
Less Depreciation		
Intangible Assets		
Less Amortization		
Other Assets		
Total Assets		

LIABILITIES

Accounts Payable	
Other Current Liabilities	
Loans from Shareholders	
Other Liabilities	
Total Liabilities	

The copy of [REDACTED]'s return that we have does not show what assets comprise the "Buildings and Other Depreciable Assets" and "Other Assets" categories.

On [REDACTED], the Taxpayer apparently sold his stock in [REDACTED]. The Taxpayer claimed a loss of \$[REDACTED] on the sale of his [REDACTED] stock, \$[REDACTED] of which he treated as a long-term capital loss and \$[REDACTED] of which he treated as an ordinary loss under I.R.C. § 1244.

DISCUSSION

A nonresident alien is taxed on his income in one of two ways. He is taxed on income that is effectively connected with the conduct of a U.S. trade or business, less any allowable deductions, at the graduated rates applicable to U.S. citizens. I.R.C. §§ 871(b) and 873. He is also taxed at a flat rate of 30 percent (or a reduced treaty rate) on (1) amounts received from sources within the United States as interest, dividends, rents, salaries, wages, and other fixed or determinable annual or periodic ("FDAP") income that are not effectively connected with the conduct of a U.S. trade or business and (2), in the case of a

nonresident alien individual present in the United States for 183 days or more, the amount by which his gains, derived from sources within the United States, from the sale of capital assets exceed his losses, allocable to sources within the United States, from the sale of capital assets. I.R.C. § 871(a).

I. SOURCE OF INCOME UNDER I.R.C. § 897

If a nonresident alien disposes of a "United States real property interest," he shall recognize gain or loss on such disposition as if he were engaged in a trade or business within the United States during the taxable year and as if the gain or loss on the disposition were effectively connected with such trade or business. I.R.C. § 897(a)(1).

The term "United States real property interest" means an interest in real property located in the United States. I.R.C. § 897(c)(1)(A)(i). An "interest in real property" includes fee ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, as well as movable walls, furnishings, and other personal property associated with the use of the real property. I.R.C. §§ 897(c)(6)(A) and (B).

The term "United States real property interest" also means any interest (other than that of a creditor) in any domestic corporation, unless the nonresident alien can establish that the corporation was at no time during the five-year period ending on the date of disposition a "United States real property holding corporation." I.R.C. § 897(c)(1)(A)(ii). The term does not include, however, any interest in a corporation if

1. as of the date of the disposition, the corporation did not hold any United States real property interests, and
2. all of the United States real property interests held by the corporation during the five-year period ending on the date of disposition were disposed of in transactions in which the full amount of the gain was recognized.

I.R.C. § 897(c)(1)(B).

The term "United States real property holding corporation" means any corporation if the fair market value of its United

States real property interests equals or exceeds 50 percent of the fair market value of

1. its United States real property interests,
2. its interests in real property located outside the United States, plus
3. any other assets that are used or held for use in the corporation's trade or business.

I.R.C. § 897(c)(2) (the "50-Percent Test").

Recommendations

(b)(5)(AWP), (b)(5)(AC)

1. (b)(5)(AWP), (b)(5)(AC)

Interests in a United States real property holding corporation immediately cease to be United States real property interests as of the first date on which the following conditions are met:

1. the corporation does not hold any United States real property interests, and
2. all of the United States real property interests directly or indirectly held by the corporation at any time during the previous five years were directly or indirectly disposed of in transactions in which the full amount of the gain was recognized.

Treas. Reg. § 1.897-2(f)(2). Since gain is recognized at the corporate level on a distribution (including distributions in liquidation) under either I.R.C. §§ 311(b) or 336(a) of a United States real property interest, such distribution is considered a disposition for this purpose. Treas. Reg. § 1.897-5T(b)(2). That is, a nonresident alien will not recognize gain or loss under I.R.C. § 897(a) on a liquidation of a corporation in which he owns stock, because the corporation will have recognized gain under I.R.C. § 336(a) on the distribution of its assets, including its

United States real property interests. See Treas. Reg.
§ 1.897-5T(b)(5) Ex. 1.

(b)(5)(AWP), (b)(5)(AC)

(b)(5)(AWP), (b)(5)(AC)

2. (b)(5)(AWP), (b)(5)(AC)

(b)(5)(AWP), (b)(5)(AC)

I.R.C. § 897 creates a presumption that stock in a United States corporation is a United States real property interest. I.R.C. § 897(c)(1)(A)(ii). The presumption is overcome by showing that the United States corporation was not a United States real property holding corporation (i.e., the fair market value of the corporation's United States real property interests equals or exceeds 50 percent of the fair market value of the corporation's assets) during the five-year period ending on the date of disposition. I.R.C. §§ 897(c)(1)(A)(ii) and (c)(2).

(b)(5)(AWP), (b)(5)(AC)

(b)(5)(AWP), (b)(5)(AC)

(b)(5)(AWP), (b)(5)(AC)

(b)(5)(AWP), (b)(5)(AC)


Ownership or leasehold interests in land or buildings are included in the definition of "United States real property interest." I.R.C. § 897(c)(6)(A). In some very limited situations not relevant here, personal property associated with the use of real property will be a United States real property interest. Treas. Reg. § 1.897-1(b)(4). Generally, personal property is not a United States real property interest but is considered as used in the trade or business for purposes of the 50 percent test of I.R.C. § 897(c)(2). See I.R.C. § 897(c)(6)(B). Personal property so treated includes:

1. stock in trade of an entity or other property of a kind which would properly be included in the inventory of the entity if on hand at the close of the taxable year, or property held by the entity primarily for sale to customers in the ordinary course of its business;
2. depreciable property used or held for use in the trade or business;
3. goodwill and going concern value, patents, inventions, formulas, copyrights, trademarks, franchises, licenses, customer lists, and other similar intangible property used or held for use in the entity's business; and
4. cash, stock, securities, and receivables of all kinds used or held for use in the entity's business.

Treas. Reg. § 1.897-1(f).

(b)(5)(AC)

(b)(5)(AWP), (b)(5)(AC)



Once the Service has this information, it can determine whether the Taxpayer's loss on the sale of [REDACTED] stock is effectively connected with the conduct of a trade or business in the United States. We will gladly assist you in this matter.

Effect on Application of I.R.C. § 1244

If the Taxpayer's loss on the sale of [REDACTED] stock is effectively connected with the conduct of a trade or business in the United States pursuant to I.R.C. § 897, the Taxpayer can take advantage of the principle set forth in I.R.C. § 1244.

I.R.C. § 1244 allows an individual to treat a loss on the sale of "section 1244 stock" as an ordinary loss in an amount not to exceed \$50,000, or, in the case of a husband and wife filing a joint return, \$100,000. I.R.C. §§ 1244(a) and (b). The term "section 1244 stock" means stock in a domestic corporation if

1. at the time the stock is issued, the corporation was a small business corporation,¹
2. the stock was issued by the corporation for money or other property (other than stock and securities), and
3. the corporation, during the period of its five most recent taxable years ending before the date the loss on the stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sale or exchanges of stocks or securities.

I.R.C. § 1244(c)(1).

In this case, the Service has determined that the Taxpayer's stock in [REDACTED] qualifies as section 1244 stock. The Taxpayer, therefore, is entitled to treat \$50,000 of the loss on the stock

¹ A corporation is a small business corporation if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed \$1,000,000. I.R.C. § 1244(c)(3).

as an ordinary loss. The Taxpayer is not entitled to treat \$ [REDACTED] of the loss as an ordinary loss, as claimed on his [REDACTED] Form 1040NR, because (1) he did not file a joint return with his wife and (2) as a nonresident alien, he is not permitted to file a joint return with his wife.

II. SOURCE OF INCOME UNDER I.R.C. § 865

If the Taxpayer's loss on the sale of [REDACTED] stock is not effectively connected with the conduct of a trade or business in the United States pursuant to I.R.C. § 897, the Taxpayer must look to other provisions to determine whether the loss is sourced in the United States.

Income from the sale of personal noninventory property by a U.S. resident is sourced in the United States, and income from the sale of personal noninventory property by a nonresident is sourced outside the United States. I.R.C. § 865(a). Similarly, loss from the sale of personal noninventory property by a U.S. resident generally is sourced in the United States, and loss from the sale of personal noninventory property by a nonresident generally is sourced outside the United States. International Multifoods Corp. v. Commissioner, 108 T.C. 579, 589; see also Treas. Reg. § 1.865-2 (promulgated on January 8, 1999).

The sale of stock is a sale of personal noninventory property. See International Multifoods, 108 T.C. at 584. In this case, therefore, the Taxpayer's sale of his [REDACTED] stock is governed by the sourcing rules of I.R.C. § 865. Because the Taxpayer is a resident of Mexico, and not of the United States, the loss that he realized on the sale is sourced outside the United States and is not deductible on his [REDACTED] Form 1040NR.

I.R.C. § 865 contains several exceptions to the general rule described immediately above. For example, I.R.C. § 865(e) provides a special rule for the sale of personal property by a nonresident alien who maintains an office or other fixed place of business in the United States. None of the exceptions apply to the facts in this case.

If you have any questions, please call me at (619) 577-6014.

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By: /s/
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